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Dr Sarah Bachelard
The Secretary
Senate Economics Legislation Committee
Room SG.64
Parliament House
CANBERRA ACT 2600

Dear Dr Bachelard

TAXATION LAWS AND AMENDMENT BILL (NO.7) 2003 - SUBMISSION

Thank you for the invitation to make a submission regarding the provisions of Taxation Laws Amendment Bill (No.7) 2003 ("Bill No.7"). We have restricted our comments exclusively to the proposed consolidation regime transitional provisions of relevance to companies with carry forward foreign losses as contained in Schedule 5 of Bill No.7.

1. Introduction

As detailed below, we believe that the enactment of these Bill No.7 provisions is essential in order to avoid what would otherwise be extremely anomalous and inequitable outcomes.

In particular, those anomalies/inequities would arise for companies that had incurred expenses for the purposes of producing future foreign source assessable income but where, under the provisions of section 79D of the Income Tax Assessment Act 1936 the deduction for those expenses was required to be deferred pending the derivation of the related foreign income. In such cases, without the application of these proposed provisions the consolidation regime would dramatically erode a group's ability to utilise these deferred losses when related foreign income was subsequently derived.

2. Consolidation Regime Policy for the Utilisation of Losses

A key principle that underpins the consolidation regime's intended treatment of losses is as stated in section 707-305(3):

> *"...that the amount of a transferred loss that the transferee can utilise is to reflect the amount of the loss that the transferor could have utilized for the income year if the transferor of the loss ... had not become a member of a consolidated group at the time of the transfer."*

Further elaboration of this principle is contained in paragraph 8.2 of the Explanatory Memorandum to New Business Tax System (Consolidation) Bill (No.1) 2002 which states:

> *"The use of transferred losses by a consolidated group is restricted so that losses will be used by a group at approximately the same rate they would have used by the joining entity had it remained outside the group. The aim is to ensure that the treatment of transferred losses is not a motive in deciding to consolidate a group or in a consolidated group deciding to acquire a loss company."*

The existing legislated consolidation provisions broadly achieved these objectives in relation to tax losses associated with Australian sourced income ("domestic losses"), however, clearly this was not the case in relation to foreign losses. While this problem had been brought to the attention of and acknowledged by the Government and Treasury/Australian Taxation Office executives some time ago, it is only via these Bill No.7 provisions that a mechanism for seeking to satisfy this policy objective has been able to be formulated in the light of the specific pre-consolidation restrictions relating to foreign losses.

3. Technical Background

3.1 The Pre-consolidation Regime Position

While section 79D carried forward foreign losses have never been groupable as was the case for domestic losses, in commercial structures the group subsidiary that generates the foreign loss will also own the related asset/business that, when profitable, will generate foreign income of the same class. As such, the pre-consolidation regime position was such that carry forward foreign losses could normally be **fully offset** against foreign income derived in a subsequent year.

3.2 Consolidation Regime Without Bill No.7 Amendments

As currently enacted (ie. excluding the Bill No.7 amendments) the "available fraction" transitional concessions which satisfy the policy objective noted above in relation to domestic losses are specifically **not available** in relation to foreign losses. This is due to the fact that foreign losses were not groupable under the pre-1 July 2003 provisions.

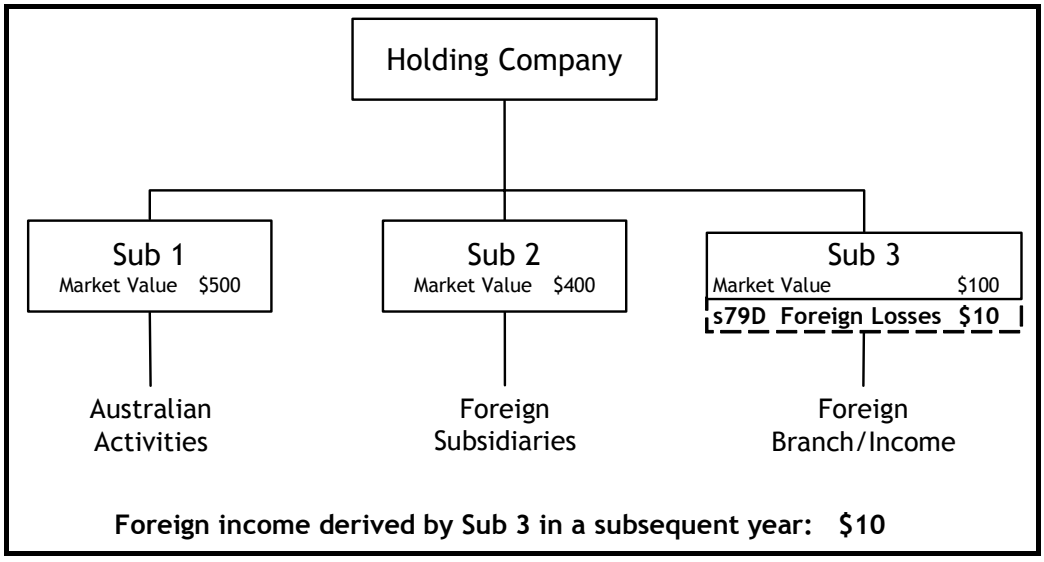
This dramatically erodes the future utilisation rate in respect of foreign losses, as in effect, it assumes that subsequent foreign income is not just derived by the original subsidiary with the foreign losses, but is derived by all group companies in proportion to their relevant market values. However, as noted above, in most cases this assumption is incorrect as it is usually only the assets of the foreign loss entity that subsequently result in the production of foreign income.

3.3 Bill No.7 Proposed Amendments

We understand that extending the available fraction transitional mechanism to foreign losses was not regarded by the Government as appropriate as these losses were not previously groupable. Therefore, the Bill No.7 amendments seek to satisfy the policy objective noted at 2. above by enabling the foreign loss entity to remain outside the consolidated group until such time that it has utilised its foreign losses, but for a maximum of three years.

3.4 Example

The above points are illustrated in the following example:



Pre-consolidation Regime Treatment:

The foreign income of $10 derived by Sub 3 could be fully offset by Sub 3's carry-forward foreign losses, with a resulting nil net foreign taxable income.

Consolidation Regime Without Bill No.7 Amendments:

The "available fraction" in respect of Sub 3's losses would be 0.1 (ie. 100/1000).

Therefore, in respect of the $10 of foreign income only $1 ($10 x .1) of foreign losses could be utilised, resulting in net taxable income of $9.

Consolidation Regime with Bill No.7 Amendments

Subject to satisfying the relevant eligibility criteria, an election could be made to exclude Sub 3 from the group for a maximum of three years or until such time as it had utilised its foreign losses. Therefore, as per the pre-consolidation regime treatment, Sub 3 would fully utilise the carry forward foreign loss of $10 against the related foreign income of $10 in the first tax year, following which it would compulsorily rejoin the consolidated tax group at the commencement of the next tax year.

4. Specific Comments Regarding the Bill No.7 Amendments

4.1 Only a Transitional Measure

The Government has been guarded in formulating the Bill No.7 amendments in that these provisions have a very targeted/restricted application. In particular, they only apply: to wholly owned subsidiaries at 1 July 2002; provided these subsidiaries themselves do not own shares in Australian group companies; and where a group elects to consolidate during the transitional period ending on 1 July 2004.

In effect, this restriction limits the application of these amendments to those groups that otherwise would have inadvertently found themselves in the position that the utilisation rate of their **existing** foreign losses would have been substantially eroded under consolidations. For groups that subsequently acquired a company with foreign losses, presumably they would do so in the knowledge that the utilisation rate of any foreign losses "acquired" would be substantially eroded and, hence, have factored this into their pricing of the acquisition.

Therefore, the Bill No.7 amendments apply only to those groups that would have previously incurred foreign related deductions in the expectation that these could have been immediately offset against subsequently derived foreign income and, hence, would otherwise unavoidably and retrospectively have had the value of their losses dramatically eroded.

4.2 Three Year Limitation

The three year limitation on the ability of the foreign loss entity to remain outside a consolidated group is again restrictive, in that many large foreign projects take some years to become "income positive".

4.3 Inability to Simultaneously Access Consolidation Benefits

Where an election is made for a foreign loss entity to remain outside a consolidated group, all consolidation regime transitional concessions and grouping facilities will not be available during that period. Therefore, while this facility addresses the inequity that otherwise would apply in relation to utilisation of foreign losses it does so at a potential cost to the group to the extent to which these other grouping concession/facilities cannot be simultaneously utilised.

4.4 Foreign Tax Credit Amendments

The Minister for Revenue's Press Release of 30 June 2003 announced that some further clarification consolidation amendments will be introduced in the near future. It is assumed that the modifications to be made in relation to foreign tax credit rules will also similarly address the treatment of foreign tax credits in the context of an entity with a foreign loss which has temporarily remained outside the group by way of this Bill No.7 mechanism.

5. Revenue Aspects

While we do not have access to information that would enable us to comment in any detail on the revenue aspects associated with these particular Bill No.7 provisions, we note the following points:

- First and most importantly, given that these provisions clearly address what would otherwise be an anomalous and inappropriate outcome by essentially allowing specific entities with foreign losses to retain the pre-existing tax treatment for a transitional period, these measures should be seen as having no revenue cost. In addition, the example at 3.4 above illustrates that the outcomes achieved are broadly consistent with the Parliament's stated policy objectives for losses under the consolidation regime (refer 2. above).

- Secondly, as a result of the restricted eligibility criteria and limited timeframe by which this facility can be utilised, arguably this measure will be revenue positive as compared to other approaches that could have been adopted to satisfy this policy objective. In particular:

  - This measure only applies to pre-1 July 2002 wholly owned subsidiaries and groups that elect to consolidate during the transitional period;

  - This facility is available only for a maximum three year period;

  - Other transitional consolidation concessions will not be available for subsidiaries in respect of which this election is made when they subsequently join the consolidated group (eg. the ability to elect to retain the existing tax value of assets); and

  - Other consolidation grouping facilities will not be available for relevant entities during this three year period.

- Thirdly, given the majority of foreign losses to which these provisions could apply would relate to foreign branch operations, in effect, they will cease to have any impact/application when foreign branch income ceases to become assessable as per the Government's announced response to the Review of International Taxation.

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We would be pleased to respond to any further questions you may have in relation to these provisions in Bill No.7, either at the public hearing scheduled for 22 August 2003 or at a later time.

Yours sincerely

Ken Spence
Partner